explicit "taxes" upon all telecommunications carriers' revenues. Whether recovered implicitly or explicitly, the cost of supporting universal service is ultimately borne by the consuming public. The problem for the new universal service system is that its costs are unknown and may, in light of inclusion of newly eligible customer groups and services, be dramatically higher than under the old regime. The issue of local exchange rates and the federal subscriber line charge cannot be viewed in isolation from the fundamental economic proposition that consumers will pay, one way or another, for universal service.

The Joint Board's position on the federal subscriber line charge suggests that disguising the costs of universal service from the public by lowering end user rates and increasing the universal service fund is appropriate. The issue of affordability must involve a weighing and balancing of what consumers can afford to pay directly, in the form of rates and charges, and the larger impact of the new universal service fund upon the economy. Consumers ultimately bear the costs of universal service funding and they can and will bear only so much overall expense before demand for telecommunications services diminishes.

VI. High Cost Support -- Affordability and Federal Fund Allocation Issues

The *Joint Board Recommendations* raise two high cost support issues of concern to the Citizens Companies. The first issue concerns determination of the affordability of universal services. This determination requires analysis of the costs of a designated universal service to determine if extrinsic funding is required in order to maintain "affordable" rates.. The second issue involves a proposed scheme to allocate federal high cost funds through a "national revenues-per-line" threshold. The Citizens Companies believe that the *Joint Board Recommendations'* treatment of both issues is problematic.

The Citizens Companies have no concern, *per se*, with the Joint Board's suggestion of factors that should be considered in addressing the affordability of universal services[22] or the proposal that the states bear the primary responsibility for determining affordability of services in their jurisdictions using the proposed criteria.[23] The Citizens Companies are concerned, however, with the proposed rejection of a national affordability standard for federally supported services. What the Joint Board appears to be recommending is that each state use the proposed criteria to determine an affordability standard that will be used at both that state and federal level. The Joint Board is apparently suggesting that the federal high cost program rely upon state affordability standards and a "national revenues-per-line" figure, based upon a variety of universal and non-universal service revenues, as a threshold to allocate available federal funds.[24]

The Citizens Companies' understanding of the Joint Board's proposal is that federal high cost funding would be available to a carrier to the extent that the difference between its state-determined "affordable" rate for universal service and the proxy-determined costs of that service exceed the "national revenues-per-line" threshold. The proposed federal high cost funding mechanism would work, on a per-line basis, in a manner illustrated in the following hypothetical example:

Proxy-determined universal service cost in area "A"	\$70.00
"Affordable" rate for universal service in area "A"	\$25.00
Difference between state-determined "affordable" rate and proxy-determined cost	\$45.00

[22] *Joint Board Recommendations* at ¶¶ *126-130.*

[23] *Id.* at ¶ 131.

[24] *Id.* at ¶¶ 131, 311.

Federal funding threshold (based upon an assumed "national revenues per line")	$30.00
Available federal funding	$15.00

This approach is deeply flawed because it appears to call for each state to set its own affordability standard for federal high cost funding. This is impractical for two reasons. First, a federal system with more than 50 different affordability thresholds for federal funding would be impossible to administer. Second, the only impediment to the full effect of a given state's sponsorship of an absurdly low affordability standard would be the economically dubious "national revenues-per-line" threshold. At that, the impediment is modest because the "national revenues-per-line" threshold would only partially ameliorate the impact of low state affordability standards. For example, if the state in the foregoing hypothetical decided that the affordable cost of universal service was $8.00 per line, the federal funding would be $32.00 per line ([$70.00-$8.00] - $30.00 =$32.00).

The issue of state affordability standards being used in federal high cost funding determination aside, the Joint Board's effort to compare a proxy-derived costing of the underlying costs of those services and "national revenues-per-line" is an "apples and oranges" comparison. The first problem with the Joint Board's approach is the mismatch between the costs and revenues in the bundles of universal and non-universal services used in the analysis. As the Joint Board would have it, the support benefits of the "national revenues-per-line" figure would offset proxy-derived universal service costs, but the costs of the non-universal services generating part of those revenues would not be considered. In the extreme, this would mean that a high cost carrier that has successfully marketed a large amount of vertical services could be disadvantaged. The Joint Board's approach could create the incentive for high cost carriers to offer no more than the core universal services. Second, while it is appropriate to exclude the costs of non-universal services, the inclusion of their revenues in the proposed funding threshold suggests continuation of implicit subsidization of universal service. This directly violates the Section 254(e) mandate that universal service funding be explicit. An appropriate analysis can only compare the cost of universal service to its revenues.

A fundamental rationale for eliminating implicit funding is that no natural, economic nexus exists between the costs of universal services and their recovery in non-universal service revenues. Instead, implicit funding was possible because of monopoly power in local exchange telephony. In a monopoly environment, local exchange carriers could, and were encouraged by regulators to, charge above-cost rates for some services to defray the costs of services priced below cost. Even if the proposed federal "national revenues-per-line" threshold recognized both costs and revenues of the non-universal services, it would still be irrelevant in universal service support determination in the new era for a fundamental reason -- monopoly power to command such implicit subsidy flows, even if its exertion remained lawful, is waning. Optimally, competition will drive prices for non-universal services to cost. The ability of local exchange carriers to even engage in implicit subsidization of universal service is diminishing and, in the long run, is doomed.

Although never articulated in the *Joint Board Recommendations*, the principles of federalism inherent in Section 254 suggest the necessity for both federal and state benchmarks for the provision of high cost funding. This is so because separate federal and state funding systems are contemplated. A federal benchmark is necessary to balance the goal of ensuring a flow of support from lower cost to higher cost states with the twin necessities of controlling the absolute size of the federal fund and preserving the states' rights to promulgate their own support programs. Sound policy dictates creation of a federal benchmark to establish a minimum of high cost support that will prevail in every part of the Nation and creation of state benchmarks, where states elect to do so, to fund a great level of high cost support at the state levels.

The Citizens Companies recommend a better approach to federal benchmarking than that suggested by the Joint Board. The Commission should set a national price affordability standard for universal service at the inception of the new universal service high cost support mechanism. A national price affordability standard should be based upon the total unseparated cost to end users for the service at issue. The national price affordability standard for a universal service recommended by the Citizens Companies is the national average rate for supported universal service, including the federal subscriber line charge,[25] plus one standard deviation. Merely setting the price affordability standard the national average rate would minimize states' incentive to eliminate implicit intrastate subsidies through local exchange rate rebalancing and would result in funding of carriers whose costs are merely at the national average. A "one standard deviation above the national average" standard would better serve to focus support on carriers with costs significantly above the national average. Periodic, future adjustments are necessary to national price affordability standards to account for inflation and/or pricing changes.

The concept of a national price affordability standard for the federal universal service basket is a necessary ingredient to achievement of the Section 254(b)(3) principle of universal service quality and pricing comparability between rural, insular and high-cost areas, on the one hand, and urban areas, on the other. Of necessity, the averaging process in arriving at a national price

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[25] The federal subscriber line charge must be added to the intrastate rate for the service in question in order to ascertain the service's total cost to the network end user.

affordability standard means an explicit export of funding dollars from urban and low-cost areas to support universal service provision in rural, insular and high-cost areas. The Citizens Companies believe this to be exactly the Congressional intent in promulgating Section 254 of the Act.

The dual jurisdictional nature of new Section 254's universal service policies suggests states' freedom to create their own affordability standards. The setting of a national price affordability standard for universal service does not in any way impede the ability of the states to create their own affordability standards for the same services. In fact, the states can do so to the extent they believe that local conditions dictate a different standard.[26] Differing state price affordability standards would have no impact upon the federal universal service mechanism because the states would need to create their own universal service mechanism to fund the difference between eligible carrier costs and the state affordability standards, net of funds received from the federal program. Since the federal program might feature a higher affordability standard than a state price affordability standard for the same service, the state would be responsible for funding the difference.

VII. Assessment of Contributions Upon Intra- and Interstate Revenues

The Joint Board recommended that support for schools and libraries and rural health care services be funded by assessments on both the intra- and interstate revenues of interstate telecommunications carriers.[27] However, it refrained from a similar recommendation for high cost

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[26] This is not to suggest, however, that the Citizens Companies believe that a state should adopt different price affordability standards. To do so would increase the size and burden of funding an intrastate universal service fund.

[27] *Joint Board Recommendations* at ¶ 817.

and low income assistance[28] because of the need for further reflection upon the "role of complementary state and federal universal service mechanisms."[29]

With all deference to the Joint Board and its recommendations on assessment issues, the need for further reflection extends to <u>all</u> aspects of universal service, not just high cost and low income assistance. Questions of what jurisdictional revenues to tax for any universal service program can only be answered after some determination is made of the amount of dollars that must be collected to fund the programs at each jurisdictional level. Simply put, an overly ambitious federal program could undermine the revenue base for complementary state programs. Further, overly ambitious federal and state programs could collectively dampen demand for telecommunications services in general, thereby diminishing the funds available for universal service at all jurisdictional levels. In short, questions of which jurisdictional revenue bases should be reached for universal service "taxation" cannot be rationally addressed until determination is made of the total amount of required state and federal funding.

The Commission should be mindful in determining the jurisdictional "tax" base of the role of the states in universal service implementation and of the necessity to eliminate carrier incentives to "forum" shop to minimize contributions to universal service funding. For these reasons, the Citizens Companies believe that it may, in the interest of maximizing the tax base, be appropriate for the federal and state funds to tax both inter- and intrastate telecommunications revenues. Further,

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[28] *Id.*

[29] *Id.* at ¶822.

the Citizens Companies believe that competitive neutrality dictates that the tax base be carriers' retail revenues, rather than gross revenues, less amounts paid to other carriers.[30]

A combination of dual jurisdictional taxation and taxation on a retail revenues base will ensure that all carriers are taxed fairly, without the distortions inherent in a given carrier's mix of wholesale and retail services. Where the tax is upon all carriers' retail revenues, each carrier will pay the same percentage on the same revenue base -- its retail revenue, rather than upon its net marginal revenue. Assessment at the retail level ensures that all retail service providers collect from the ultimate supporters of universal service -- retail customers -- on the revenue. Assessment on a carrier's gross revenue, less amounts paid other carriers, allows retail services that use "wholesale" components provided by other carriers to be assessed on the retail margin above cost, rather than the entire retail price. In contrast, retail services that do not use wholesale components supplied by other carriers will be assessed on the basis of their entire price. Payment upon a net marginal revenue base disadvantages carriers that are largely in the retail business, such as local exchange carriers in the intrastate domain, vis-a-vis carriers that are large purchases of access services, such as interexchange carriers. Taxation upon a net marginal revenues base, as recommended by the Joint Board, is not competitively neutral in that it discriminates between carriers based upon their relative mix of wholesale and retail revenues.

Conclusion

Charged, as it was, with formidable responsibilities by Congress, the Joint Board has performed an outstanding service in framing the universal service issues for ultimate Commission

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[30] *Id.* at ¶ 807.

disposition. In several major areas, such as the proposed, transitional treatment of high cost funding for rural local exchange carriers and proposed classification of supported high cost and low income services, its recommendations show careful and balanced analysis. Much remains to be done, most notably in addressing the need to balance the competing interests of universal service goals and the impact upon consumers of prices for telecommunications services that reflect, as they ultimately must, the costs of the new universal service program. The Citizens Companies trust that the Commission will not shy away from this difficult, but necessary responsibility.

Respectfully submitted,

CITIZENS UTILITIES COMPANY

Richard M. Tettelbaum, Associate General Counsel
Suite 500, 1400 16th Street, N.W.
Washington, D.C. 20036

(202) 332-5922

December 19, 1996

CERTIFICATE OF SERVICE

I, Richard M. Tettelbaum, Associate General Counsel, do hereby certify that I have this 19th day of December, 1996, delivered copies of the foregoing "Comments of Citizens Utilities Company on the Federal-State Joint Board's Universal Service Recommended Decision" via first class mail, postage prepaid, to the following:

The Honorable Reed E. Hundt
Federal Communications Commission
1919 M Street, N.W., Room 814
Washington, D.C. 20554

The Honorable Susan Ness
Federal Communications Commission
1919 M Street, N.W., Room 832
Washington, D.C. 20554

The Honorable Rachelle B. Chong
Federal Communications Commission
1919 M Street, N.W., Room 844
Washington, D. C. 20554

The Honorable Julia Johnson
Commissioner
Florida Public Service Commission
Capital Circle Office Center
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

The Honorable Kenneth McClure
Vice Chairman
Missouri Public Service Commission
301 W. High Street, Suite 530
Jefferson City, Missouri 65102

The Honorable Sharon L. Nelson
Chairman
Washington Utilities
& Transportation Commission
P.O. Box 47250
Olympia, Washington 98504-7250

The Honorable Laska Schoenfelder
Commissioner
South Dakota Public Utilities Commission
500 E. Capital Avenue
Pierre, South Dakota 57501

Martha S. Hogerty
Public Counsel for the State of Missouri
P.O. Box 7800
Harry S. Truman Building
Room 250
Jefferson City, Missouri 65102

Anna Gomez
Federal Staff Chair
Federal Communications Commission
2100 M Street, N.W., Room 8617
Washington, D.C. 20036

Paul E. Pederson, State Staff Chair
Missouri Public Service Commission
P.O. Box 360
Truman State Office Building
Jefferson City, Missouri 65102

Lisa Boehley
Federal Communications Commission
2100 M Street, N.W., Room 8605
Washington, D.C. 20554

Charles Bolle
South Dakota Public Utilities Commission
State Capitol, 500 E. Capital Avenue
Pierre, South Dakota 57501-5070

Deonne Bruning
Nebraska Public Service Commission
300 The Atrium
1200 N Street, P.O. Box 94927
Lincoln, NE 68509-4927

James Casserly
Senior Legal Advisor
Office of Commissioner Susan Ness
Federal Communications Commission
1919 M Street, N.W., Room 832
Washington, D.C. 20554

John Clark
Federal Communications Commission
2100 M Street, N.W., Room 8619
Washington, D.C. 20554

Bryan Clopton
Federal Communications Commission
2100 M Street, N.W., Room 8615
Washington, D.C. 20554

Irene Flannery
Federal Communications Commission
2100 M Street, N.W., Room 8922
Washington, D.C. 20554

Daniel Gonzalez, Legal Advisor
Office of Commissioner Rachelle B. Chong
Federal Communications Commission
1919 M Street, N.W., Room 844
Washington, D.C. 20554

Emily Hoffnar
Federal Communications Commission
2100 M Street, N.W., Room 8623
Washington, D.C. 20554

L. Charles Keller
Federal Communications Commission
2100 M Street, N.W., Room 8918
Washington, D.C. 20554

Lorraine Kenyon
Alaska Public Utilities Commission
1016 West Sixth Avenue
Suite 400
Anchorage, Alaska 99501

David Krech
Federal Communications Commission
2025 M Street, N.W., Room 7130
Washington, D.C. 20554

Debra M. Kriete
Pennsylvania Public Utilities Commission
P.O. Box 3265
Harrisburg, Pennsylvania 17105-3265

Diane Law
Federal Communications Commission
2100 M Street, N.W., Room 8920
Washington, D.C. 20554

Mark Long
Florida Public Service Commission
2540 Shumard Oak Boulevard
Gerald Gunter Building
Tallahassee, Florida 32399-0850

Robert Loube
Federal Communications Commission
2100 M Street, N.W., Room 8914
Washington, D.C. 20554

Samuel Loudenslager
Arkansas Public Service Commission
P.O. Box 400
Little Rock, Arkansas 72203-0400

Sandra Makeeff
Iowa Utilities Board
Lucas State Office Building
Des Moines, Iowa 50319

Philip F. McClelland
Pennsylvania Office of the
Consumer Advocate
1425 Strawberry Square
Harrisburg, Pennsylvania 17120

Michael A. McRae
D.C. Office of the People's Counsel
1133 15th Street, N.W., Suite 500
Washington, D.C. 20005

Tejal Mehta
Federal Communications Commission
2100 M Street, N.W., Room 8625
Washington, D.C. 20554

Terry Monroe
New York Public Service Commission
Three Empire Plaza
Albany, New York 12223

John Morabito, Deputy Chief
Accounting & Audits Division
Common Carrier Bureau
Federal Communications Commission
2000 L Street, N.W., Suite 812
Washington, D.C. 20554

Mark Nadel
Federal Communications Commission
2100 M Street, N.W., Room 8916
Washington, D.C. 20554

John Nakahata, Senior Legal Advisor
Office of Chairman Reed E. Hundt
Federal Communications Commission
1919 M Street, N.W., Room 814
Washington, D.C. 20554

Lee Palagyi
Washington Utilities and
Transportation Commission
P.O. Box 47250
Olympia, Washington 98504-7250

Kimberly Parker
Federal Communications Commission
2100 M Street, N.W., Room 8609
Washington, D.C. 20554

Barry Payne
Indiana Office of the Consumer Counsel
100 North Senate Avenue, Room N501
Indianapolis, IN 46204-2208

Jeanine Poltronieri
Federal Communications Commission
2000 L Street, N.W., Suite 257
Washington, D.C. 20036

Michael Pryor
Federal Communications Commission
2100 M Street, N.W., Room 8905
Washington, D.C. 20554

James Bradford Ramsay
National Association of
Regulatory Utility Commissioners
1201 Constitution Avenue, N.W.
Washington, D.C. 20423

Brian Roberts
California Public Utilities Commission
505 Van Ness Avenue
San Francisco, CA 94102

Gary Seigel
Federal Communications Commission
2000 L Street, N.W., Room 812
Washington, D.C. 20554

Richard D. Smith
Federal Communications Commission
2100 M Street, N.W., Room 8605
Washington, D.C. 20554

Pamela Szymczak
Federal Communications Commission
2000 L Street, N.W., Room 257
Washington, D.C. 20036

Lori Wright
Federal Communications Commission
2100 M Street, N.W., Room 8603
Washington, D.C. 20554

Matthew C. Ames
Miller, Canfield, Paddock & Stone, PLC
1225 Nineteenth Street, N.W.
Suite 400
Washington, D.C. 20036-2420

Alex Belinfante
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Eileen Brenner
Idaho Public Utilities Commission
P.O. Box 83720
Boise, Idaho 83720-0074

Jot D. Carpenter, Jr.
Vice President, Government Relations
Telecommunications Industry Association
1201 Pennsylvania Avenue, N.W.
Suite 315
Washington, D.C. 20044

David Cosson
L. Marie Guillory
Steve Watkins
NTCA
2626 Pennsylvania Avenue, N.W.
Washington, D.C. 20037

Joseph DiBella
NYNEX
1300 I Street, N.W.
Suite 400 West
Washington, D.C. 20005

Deborah Dupont
Federal Communications Commission
2000 L Street, N.W., Room 257
Washington, D.C. 20036

Michael J. Ettner
Senior Assistant General Counsel
Personal Property Division
General Services Administration
18th & F Streets, N.W., Room 4002
Washington, D.C. 20405

James R. Forcier
AirTouch Communications, Inc.
One California Street, 9th Floor
San Francisco, California 94111

Chris Frentrup
Senior Regulatory Analyst
MCI Communications Corporation
1801 Pennsylvania Avenue, N.W.
Washington, D.C. 20006

Robert C. Glazier
Director of Utilities
Indiana Utility Regulatory Commission
Indiana Government Center South
302 West Washington, Suite E306
Indianapolis, Indiana 46204

Neal M. Goldberg
The National Cable Television
Association, Inc.
1724 Massachusetts Avenue, N.W.
Washington, D.C. 20036

Maureen O. Helmer, General Counsel
New York State Department
of Public Service
Three Empire State Plaza
Albany, New York 12223

David L. Howell, II
Deputy Attorney General
Idaho Public Utilities Commission
472 West Washington Street
Boise, Idaho 83720-0074

Illona A. Jeffcoat-Sacco, Director
Public Utilities Division
Public Service Commission
State of North Dakota/State Capitol
600 E. Boulevard
Bismarck, North Dakota 58505

Michael J. Karson
Ameritech
2000 West Ameritech Center Drive
Room 4H88
Hoffman Estates, Illinois 60196-1025

Lawrence W. Katz
The Bell Atlantic Telephone Companies
1320 North Courthouse Road, 8th Floor
Arlington, Virginia 22201

Roberta R. Katz
Peter F. Harter
Netscape Communications Corporation
487 East Middlefield Road
Mountain View, California 94043

Jay C. Keithley
Leon M. Kastenbaum
H. Richard Juhnke
Sprint Corporation
1850 M Street, N.W., Suite 1100
Washington, D.C. 20036

Linda Kent
United States Telephone Association
1401 H Street, N.W., Suite 600
Washington, D.C. 20005

Wayne A. Leighton, PhD.
James L. Gattuso
Citizens for a Sound Economy Foundation
1250 H Street, N.W., Suite 700
Washington, D.C. 20005

J. Manning Lee
Vice President, Regulatory Affairs
Teleport Communications Group, Inc.
Two Teleport Drive, Suite 300
Washington, D.C. 20007

Jill A. Lesser
People for the American Way
2000 M Street, N.W.
Washington, D.C. 20036

Robert F. Manifold
Assistant Attorney General
Public Counsel Section
Office of the Attorney General
900 Fourth Avenue, Suite 2000
Seattle, Washington 98164

Richard McKenna, HQE03J36
GTE Service Corporation
P.O. Box 152092
Irving, Texas 75015-2092

Cynthia B. Miller, Senior Attorney
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399

Terry Monroe
New York Public Service Commission
Three Empire Plaza
Albany, New York 12223

Genevieve Morelli
Vice President and General Counsel
The Competitive Telecommunications Association
1140 Connecticut Avenue, N.W.
Suite 220
Washington, D.C. 20036

James A. Nappi, Esquire
Secretary
State of New Jersey
Board of Public Utilities
Two Gateway Center
Newark, New Jersey 07102

Mark Nadel
Federal Communications Commission
1919 M Street, N.W., Room 542
Washington, D.C. 20554

Larry Povich
Federal Communications Commission
1919 M Street, N.W.
Washington, D.C. 20554

Dena S. Puskin, Sc.D., Deputy Director
Office of Rural Health Policy
5600 Fishers Lane, Room 9-05
Rockville, Maryland 20857

Jonathan Reel
Federal Communications Commission
505 Van Ness Avenue
San Franscisco, California 94102-3298

Richard W. Riley, Secretary
Department of Education
600 Independence Avenue, S.W.
Washington, D.C. 20202

Paul Rogers
Charles D. Gray
National Association of Regulatory
Utility Commissioners
1201 Constitution Avenue, Suite 1102
Washington, D.C. 20044

Judy Sello
AT&T Corporation
Room 3244J1
295 North Maple Avenue
Basking Ridge, New Jersey 07920

Gigi B. Sohn
Media Access Project
2000 M Street, N.W.
Washington, D.C. 20036

Allen P. Stayman, Director
Office of Insular Affairs
U.S. Department of Interior
1849 C Street, N.W.
Washington, D.C. 20240

Jeffrey Stewart
Public Service Commission
of the District of Columbia
Suite 815
450 Fifth Street, N.W.
Washington, D.C. 20001

M. Robert Sutherland
Richard M. Sbaratta
Rebecca M. Lough
BellSouth Corporation
Suite 1700
1155 PeachTree Street, N.E.
Atlanta, Georgia 30309-3610

Whiting Thayer
Federal Communications Commission
2000 L Street, N.W., Room 812
Washington, D.C. 20036

Emily M. Williams
Association for Local Telecommunications
Services
1200 19th Street, N.W.
Washington, D.C. 20036

Lisa M. Zaina
Ken Johnson
OPASTCO
21 Dupont Circle, N.W.
Suite 700
Washington, D.C. 20036

David W. Zesiger, Esquire
Office of Advocacy
U.S. Small Business Administration
409 Third Street, S.W.
Suite 7800
Washington, D.C. 20416

International Transcription Service
1919 M Street, N.W.
Room 246
Washington, D.C. 20554

Richard M. Tettelbaum